Supreme Court, U. S.
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MICHAEL RODAK, JR., CLERK

UNITED STATES SUPREME COURT

BLAINE M. and VIRGINIA C. MADDEN,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

NO. 75-806

ON APPEAL FROM THE DECISION OF THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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UNITED STATES SUPREME COURT

BLAINE M. and VIRGINIA C. MADDEN, Petitioners,	)	
v.	)	NO. _____
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	

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COMMISSIONER OF INTERNAL REVENUE,	)	
	)	
Respondent.	)	

Comes now the Petitioners in compliance with Rule 23 of the United States Supreme Court Rules alleging the following:

I

The above entitled action was first decided by the United States Tax Court reported at 57 TC 513 (1972) and is set out in full in the Appendix attached hereto. Timely appeal was perfected by the Commissioner of Internal Revenue to the Ninth Circuit, United States Court of Appeals. The Court of Appeals decision reversing the United States Tax Court is reported at 514 F.2d 1149 (1975), and is set out in full in the Appendix attached hereto.

II

Petitioners seek review of the Ninth Circuit Court of Appeals decision rendered on April 9, 1975. From this adverse holding, Petitioners made an immediate request for re-hearing before the Ninth Circuit Court of Appeals. On September 5, 1975, the Petition for re-hearing was denied.

Petitioners rely on 28 U.S.C.A. 1251(1) as conferring jurisdiction on this Court to review the Judgment of the Ninth Circuit Court of Appeals pursuant to a writ of Certiorari.

III

Petitioners were actively engaged in orchard farming, cultivating apple and pear trees. In response to a governmental condemnation action of their

orchard property, Petitioners maintained an action contesting the government's right to take a fee interest in Petitioners' orchards versus the less drastic alternative of a flowage easement. The question presented for review by this Court is whether legal fees incurred in the defense of the Petitioners' business interest in their orchards against governmental condemnation are deductible expenses under Internal Revenue Code Section 162 as ordinary and necessary business expenses.

IV

The statute involved is Internal Revenue Code of 1954, Section 162 entitled Trade or Business Expenses. Specifically, Internal Revenue Code Section 162(a) In General is set out in full in the Appendix attached hereto. Internal Revenue Code Regulation 1.162-1(a) In General which expands on Internal Revenue Code

Section 162 is set out in full in the Appendix attached hereto.

V

The material facts to the consideration of the questions presented as related here are taken from the United States Tax Court opinion set out in 57 TC 513.

Blaine M. Madden (herein called petitioner) is a commercial orchardist who owns and operates an orchard near Brewster, Washington. During the years in question the petitioner raised both apples and peaches. A tract of the orchard had been set aside prior to December 31, 1965, by the petitioners as a possible future homesite and was deeded to petitioner's wife, Virginia C. Madden.

On January 12, 1966, a petition in condemnation (Civil Action No. 16897) was filed in the Washington State Superior Court for Okanogan County by Public Utility

District No. 1 of Douglas County, Washington (hereinafter called P.U.D.) against the petitioners herein and others. P.U.D. sought to obtain fee simple ownership of certain property, including the "homesite" property of the petitioners, for use as reservoir area for the Wells Hydroelectric Dam Project.

Prior to the institution of the condemnation proceeding in the Superior Court for Okanogan County, the petitioner had subdivided a part of his property into lots which he valued at less than $3,000.00 each. He had deeded lots to each of his five children and one to his wife, Virginia. These were gifts. Except for the lot which was deeded to his wife, the subdivided area was shoreland which was not then part of the petitioner's orchard. The shoreland property deeded to his children was held primarily for the future expansion of the orchard and,

secondarily, for possible sale as recreational property. The property deeded to the wife was an integral part of the orchard and was in production when the condemnation proceeding was instituted.

Pursuant to stipulation the condemnation proceeding involving the "homesite" property was consolidated with two other similar proceedings, namely Civil Action Nos. 16839 and 16911.

In the use and necessity hearings of the condemnation proceeding, the petitioners herein contended that P.U.D. was entitled to only a flowage easement in the "homesite" property. The Superior Court's ruling was favorable to the petitioners, and P.U.D. was limited to flowage easement in the property rather than a fee simple interest. The Superior Court's order adjudicating public use and necessity was filed on June 24, 1966.

P.U.D. sought review of the Superior

Court's decision by the Washington State Supreme Court. By a decision filed on December 14, 1966, the Supreme Court reversed the Superior Court and determined that P.U.D. was entitled to a fee simple interest in the petitioners' property. The decision became final on March 8, 1967. The decision is reported as Public Utility District No. 1 of Douglas County v. Cooper, 69 Wn. 2d 909, 421 P.2d 1002 (1966). On remand, the Superior Court entered an order favorable to P.U.D. in accordance with a stipulation of the parties.

During the time the Superior Court's decision in petitioners' case was on appeal to the Washington State Supreme Court, P.U.D. instituted a condenmation proceeding in the United States District Court for the Eastern District of Washington, Northern Division, to acquire 13 acres of the petitioner's orchard. In that proceeding the petitioners contended that P.U.D.

was entitled to only a flowage easement in the property, but the Court's order adjudicating public use and necessity granted P.U.D. a fee simple interest therein.

Petitioners' legal expenses incurred in connection with the use and necessity hearings of the condemnation proceeding in the State courts amounted to $5,299.21 for the taxable year ended June 30, 1966. Petitioners' legal expenses incurred in connection with the use and necessity hearings of the condemnation proceedings in both the State and Federal courts amounted to $4,562.00 for the taxable year ended June 30, 1967. These amounts did not relate to negotiations on behalf of the petitioners herein with respect to the amount of compensation to be paid by P.U.D. for the condemned property. Petitioners deducted these amounts on their federal income tax returns as current expenses.

Petitioners retained legal counsel

to ascertain the value of the condemned property and to negotiate with P.U.D. concerning the compensation to be paid for the property. The cost to the petitioners of appraisal and legal services was $9,125.00. This sum expended for negotiation and ascertainment of purchase price was added to the basis of the condemned property and is not at issue in this case.

None of the legal expenses involved in this case are attributable to the shoreland property deeded to the five children. In the State court proceedings the only property in which petitioners sought to limit the taking to a flowage easement was the "homesite" property, i.e., the portion of the orchard deeded to Virginia C. Madden. The only legal expenses involving the shoreland property were those connected with the $9,125.00 negotiation expense which was capitalized by petitioners.

Petitioners reported the receipt of $84,000.00 on their federal income

tax return for the year ended June 30, 1967, representing compensation received from P.U.D. for the condemned property. They believed that the compensation from P.U.D. would be the same whether P.U.D. were granted fee simple title to the condemned property or merely a flowage easement.

During the taxable year ended June 30, 1967, the petitioners were assessed $500.00 by Mid-Columbia Planners, an organization of landowners in the Brewster-Pateros area of which the petitioner is a member. Petitioners deducted this amount on their federal income tax return as a current expense. The $500.00 was used by Mid-Columbia Planners to pay a portion of the legal expenses incurred by parties contesting P.U.D.'s condemnation in fee simple of certain other property similarly situated to that of the petitioners herein. The decision on appeal in that case is reported as Chapman v. Public Utility District No. 1 of Douglas County, Washington,

367 F.2d 163 (9th Cir. 1966). In that case the Court of Appeals held that P.U.D. was entitled to a fee simple interest in the land which it sought to condemn rather than merely a flowage easement.

Petitioners paid $500.00 to Mid-Colmbia Planners during the taxable year ended June 30, 1967, as legal fees in the belief that the outcome of the Chapman case would have an effect on their own property.

In his notice of deficiency dated May 18, 1970, respondent determined that the claimed deductions for legal expenses of $5,299.21 in the taxable year ended June 30, 1966, and $5,062.00 in the taxable year ended June 30, 1967, should be disallowed because they constituted capital expenditures.

VI

Jurisdiction in the United States Tax Court to hear Petitioners' Protest contesting the disallowance of the legal fees as current expenses was conferred under Internal Revenue Code Section 6212

and 6213. A letter of deficiency for income tax was issued by the Commissioner of Internal Revenue and Petitioner timely filed a petition in the United States Tax Court for review within ninety days therefrom.

VII

It is Petitioners' position that the Ninth Circuit Court of Appeals, has misapplied the test for deductibility of business expenses, as set out by decision of this court, resulting in a decision on a federal issue that is in conflict with applicable decisions of this court. As noted by the Ninth Circuit Court of Appeals, the Supreme Court formulated a test to distinguish between currently deductible expenses and expenses that are capital in nature. Woodworth v. Commissioner, 397 U.S. 572 (1970). In determining if the expenses incurred in the sale or acquisition of the land were to be capitalized, the Supreme Court inquired whether

the origin of the claim litigated is in the process of acquisition itself. Id. 397 U.S. at 577. The use of the "origin and character test" was for characterization of litigation expenses as either currently deductible or capitalized.

The Ninth Circuit Court of Appeals maintains that the "underlying lawsuit did not arise out of taxpayer's business, but out of the need of a governmental agency for taxpayer's land." Madden v. C.I.R. (1975). As such, the Court of Appeals found that the controversy related to the sale and acquisition of petitioners' land, even though the ultimate sale, is a forced sale.

Petitioners contend that their responsive action was intended for and did relate to the defense of their orchard business in preserving the reality on which their fruit bearing trees were rooted. As orchard farming is dependent on the free use and

availability of land, defense against the goverment action to condemn the orchard goes to the very heart of petitioners' business. Petitioners therefore forcefully contend that their lititgation expenses incurred are currently deductible business expenses within the origin and character test enunciated in Woodward v. Commissioner, supra.

Respectfully submitted,

Robert E. Kovacevich

APPENDICES

BLAINE M. AND VIRGINIA C. MADDEN, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 5130-70. Filed January 24, 1972.

Held, that legal fees paid by petitioners in unsuccessful attempts to limit the condemnation of their commercial orchard property by a public utility district to the taking of a flowage easement rather than a fee simple interest are deductible as ordinary and necessary expenses of such business under sec. 162(a), I.R.C. 1954. *L. B. Reakirt*, 20 B.T.A. 1206, affirmed per curiam 84 F.2d 906 (C.A. 6, 1936), followed.

Blaine M. Madden, pro se.
Thomas N. Tomashek, for the respondent.

DAWSON, *Judge:* Respondent determined the following deficiencies in the petitioners' Federal income taxes:

Taxable year ended	*Deficiency*
June 30, 1965	$137.00
June 30, 1966	1,529.57
June 30, 1967	369.00
June 30, 1968	322.00

Various issues have been conceded by the parties. The only issue presented for our decision is whether amounts paid by petitioners during the taxable years 1966 and 1967 in unsuccessfully attempting to limit the condemnation of their real property to the taking of a flowage easement rather than a fee simple interest constitute nondeductible capital expenditures or deductible expenses under either section 162 or section 212.[1]

FINDINGS OF FACT

The parties have stipulated certain facts which are incorporated herein by this reference.

Blaine M. Madden and Virginia C. Madden (herein called petitioners) are husband and wife whose legal residence was Brewster, Wash., when they filed their petition in this proceeding.

Petitioners filed joint Federal income tax returns for the taxable years ended June 30, 1965, through June 30, 1968, with the district director of internal revenue at Tacoma, Wash. For the taxable year ended June 30, 1965, petitioners timely filed an amended return and a claim for refund. The sum of $511.40, representing income tax of $479.60 and statutory interest of $31.80, was refunded to petitioners on November 30, 1966.

Blaine M. Madden (herein called petitioner) is a commercial orchardist who owns and operates an orchard near Brewster, Wash.

[1] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

During the years in question the petitioner raised both apples and peaches. A tract of the orchard had been set aside prior to December 31, 1965, by the petitioners as a possible future homesite and was deeded to petitioner's wife, Virginia C. Madden.

On January 12, 1966, a petition in condemnation (Civil Action No. 16897) was filed in the Washington State Superior Court for Okanogan County by Public Utility District No. 1 of Douglas County, Wash. (hereinafter called P.U.D.), against the petitioners herein and others. P.U.D. sought to obtain fee simple ownership of certain property, including the "homesite" property of the petitioners, for use as reservoir area for the Wells Hydroelectric Dam Project.

Prior to the institution of the condemnation proceeding in the Superior Court for Okanogan County, the petitioner had subdivided a part of his property into lots which he valued at less than $3,000 each. He had deeded lots to each of his five children and one to his wife, Virginia. These were gifts. Except for the lot which was deeded to his wife, the subdivided area was shoreland which was not then part of the petitioner's orchard. The shoreland property deeded to his children was held primarily for the future expansion of the orchard and, secondarily, for possible sale as recreational property. The property deeded to the wife was an integral part of the orchard and was in production when the condemnation proceeding was instituted.

Petitioner subdivided the shoreland property into lots in order to obtain greater compensation from P.U.D. when the lots were condemned.

Pursuant to stipulation the condemnation proceeding involving the "homesite" property was consolidated with two other similar proceedings, namely Civil Action Nos. 16839 and 16911.

In the use and necessity hearings of the condemnation proceeding, the petitioners herein contended that P.U.D. was entitled to only a flowage easement in the "homesite" property. The Superior Court's ruling was favorable to the petitioners, and P.U.D. was limited to flowage easement in the property rather than a fee simple interest. The Superior Court's order adjudicating public use and necessity was filed on June 24, 1966.

P.U.D. sought review of the Superior Court's decision by the Washington State Supreme Court. By a decision filed on December 14, 1966, the Supreme Court reversed the Superior Court and determined that P.U.D. was entitled to a fee simple interest in the petitioners' property. The decision became final on March 8, 1967. The decision is reported as *Public Utility District No. 1 of Douglas County* v. *Cooper*, 69 Wash. 2d 909, 421 P. 2d 1002 (1966). On remand, the Superior Court entered an order favorable to P.U.D. in accordance with a stipulation of the parties.

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During the time the Superior Court's decision in petitioners' case was on appeal to the Washington State Supreme Court, P.U.D. instituted a condemnation proceeding in the U.S. District Court for the Eastern District of Washington, Northern Division, to acquire 13 acres of the petitioner's orchard. In that proceeding the petitioners contended that P.U.D. was entitled to only a flowage easement in the property, but the court's order adjudicating public use and necessity granted P.U.D. a fee simple interest therein.

Petitioners' legal expenses incurred in connection with the use and necessity hearings of the condemnation proceeding in the State courts amounted to $5,299.21 for the taxable year ended June 30, 1966. Petitioners' legal expenses incurred in connection with the use and necessity hearings of the condemnation proceedings in both the State and Federal courts amounted to $4,562 for the taxable year ended June 30, 1967. These amounts did not relate to negotiations on behalf of the petitioners herein with respect to the amount of compensation to be paid by P.U.D. for the condemned property. Petitioners deducted these amounts on their Federal income tax returns as current expenses.

Petitioners retained legal counsel to ascertain the value of the condemned property and to negotiate with P.U.D. concerning the compensation to be paid for the property. The cost to the petitioners of appraisal and legal services was $9,125. This sum expended for negotiation and ascertainment of purchase price was added to the basis of the condemned property and is not at issue in this case.

None of the legal expenses involved in this case are attributable to the shoreland property deeded to the five children. In the State court proceedings the only property in which petitioners sought to limit the taking to a flowage easement was the "homesite" property, i.e., the portion of the orchard deeded to Virginia C. Madden. The only legal expenses involving the shoreland property were those connected with the $9,125 negotiation expense which was capitalized by petitioners.

Petitioners reported the receipt of $84,000 on their Federal income tax return for the year ended June 30, 1967, representing compensation received from P.U.D. for the condemned property. They believed that the compensation from P.U.D. would be the same whether P.U.D. were granted fee simple title to the condemned property or merely a flowage easement.

During the taxable year ended June 30, 1967, the petitioners were assessed $500 by Mid-Columbia Planners, an organization of landowners in the Brewster-Pateros area of which the petitioner is a member. Petitioners deducted this amount on their Federal income tax return as a current expense. The $500 was used by Mid-Columbia Planners to pay a portion of the legal expenses incurred by parties contesting P.U.D.'s condemnation in fee simple of certain other prop-

erty similarly situated to that of the petitioners herein. The decision on appeal in that case is reported as *Chapman* v. *Public Utility District No. 1 of Douglas Co., Wash.*, 367 F. 2d 163 (C.A. 9, 1966). In that case the Court of Appeals held that P.U.D. was entitled to a fee simple interest in the land which it sought to condemn rather than merely a flowage easement.

Petitioners paid $500 to Mid-Columbia Planners during the taxable year ended June 30, 1967, as legal fees in the belief that the outcome of the *Chapman* case would have an effect on their own property.

In his notice of deficiency dated May 18, 1970, respondent determined that the claimed deductions for legal expenses of $5,299.21 in the taxable year ended June 30, 1966, and $5,062 in the taxable year ended June 30, 1967, should be disallowed because they constituted capital expenditures.

OPINION

At the outset we observe that the respondent has tried to inject a "personal" versus "business" property issue into this case by attempting to attribute some of the disputed legal expenses to the shoreland property deeded to petitioners' children. The record shows, however, that the State court proceedings never sought to limit the taking of the shoreland property to a flowage easement. As our findings of fact reflect, the only legal expenses incurred in connection with the taking of such property were those pertaining to the negotiation of the sales price and were properly capitalized by the petitioners.

Respondent also urges us to deny any legal expense deduction for that portion of the orchard property deeded by petitioner to his wife because of their hopes eventually to build a home thereon. The record shows, however, that after the transfer such portion of the orchard property continued to be used by petitioners in conducting their commercial orchard business. Consequently, we think the legal expenses attributable to that portion of the orchard property should be treated in the same manner as those attributable to the remainder of the orchard property.

Petitioners contend that the legal expenses incurred in opposing the taking of a fee simple interest in their orchard property are properly deductible under section 162(a), which allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. They rely on our opinion in *L. B. Reakirt*, 29 B.T.A. 1296 (1934), affirmed per curiam 84 F. 2d 996 (C.A. 6, 1936). Alternatively, petitioners assert that the legal expenses in question are deductible under section 212(2) because they "related to the protection or preservation of income-producing property," citing *Ruoff* v. *Commissioner*, 277 F. 2d 222 (C.A. 3, 1960), reversing 30 T.C. 204 (1958).

To the contrary, respondent contends that the legal fees relating to the condemnation of the orchard property do not come within the ambit of deductibility provided by either section 162(a) or section 212. His arguments are three-pronged.

First, he urges us to apply the rationale of *United States* v. *Gilmore*, 372 U.S. 39 (1963), that the origin and character of the claim with respect to which an expense is incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense is "business" or "personal." The characterization as business or personal, he says, depends on whether the claim arose directly in connection with the taxpayer's profit-seeking activities and does not depend on the consequences that might result to the taxpayer's income-producing property from failure to defeat the claim. From this premise it is argued that the claim with respect to which a portion of the petitioners' legal expenses were incurred, namely, the condemnation of the orchard property in fee simple, did not stem from any income-producing activity of the petitioners. He asserts that the evidence shows that petitioners' expenses for legal fees arose solely as a result of their dislike of the consequences of the proposed condemnation proceedings, and therefore had no relationship to the business or personal nature of the property.

Respondent's second argument is that the legal fees expended by petitioners are in the nature of capital outlays incurred in effectuating the sale of their property to P.U.D. Respondent says that there is no sound reason for distinguishing between the treatment to be accorded the legal fees expended for negotiation of the compensation for the property taken and the treatment of the legal fees expended in attempting to determine the extent of the property interest to be taken. A condemnation is much like a sale of property despite the fact that the owner parts with his property involuntarily. Both price and subject matter or quantity are among the necessary terms of a sale, and the quantity of property to be taken would be an essential element of the proposed transaction between the petitioners and P.U.D. Thus, he emphasizes that it is logical to consider the condemnation proceedings in the instant case to be in the nature of negotiating sessions to determine the quantity (fee simple or flowage easement) of the property which was to be purchased by P.U.D. In support of this view respondent relies heavily on *Spangler* v. *Commissioner*, 323 F. 2d 913 (C.A. 9, 1963), affirming a Memorandum Opinion of this Court. In *Spangler* the taxpayer was fraudulently induced to sell certain corporate stock. She brought suit against the wrongdoers and recovered (1) an amount equal to quarterly dividends issued on taxpayer's stock

after the fraudulent sale, (2) an amount equal to a liquidating payment issued on her stock less the consideration received by taxpayer in the fraudulent sale, and (3) interest on each quarterly dividend and the net liquidating payment from the dates of issuance. The Court of Appeals concluded that the gist of the controversy in the taxpayer's suit had been the ownership of the stock, and accordingly the costs of the litigation were capital expenditures not deductible from ordinary income. In so concluding, it said at page 921:

> Moreover, the result would not be changed if the litigation were viewed as action taken to effectuate the initial sale of the stock to the wrongdoers, though on revised terms. Costs connected with the disposition of a capital asset are also capital expenditures to be added to taxpayer's basis, or offset against the sales price, rather than expenses deductible from ordinary income.[21] [Footnote omitted.]

Thus, respondent asserts that if the rationale of *Spangler* is applied here, it follows that the legal fees expended by petitioners in attempting to limit the extent of the condemnation of the property constitute costs connected with the disposition thereof and, as such, they are not deductible but must be capitalized. See *Williams* v. *Burnet*, 59 F. 2d 357 (C.A.D.C. 1932), affirming 21 B.T.A. 109 (1930); *Isaac G. Johnson & Co.* v. *United States*, 149 F. 2d 851 (C.A. 2, 1945).

Respondent's third contention is that the legal fees in question were incurred by petitioners to defend title to their property and therefore must be capitalized. See sec. 1.263(a)-2(c) and sec. 1.212-1(k), Income Tax Regs.; *William F. Wallace, Sr.*, 56 T.C. 624 (1971); *J. Bryant Kasey*, 54 T.C. 1642 (1970); *Midco Oil Corporation*, 20 T.C. 587 (1953); *James C. Coughlin*, 3 T.C. 420 (1944); and *United States* v. *Wheeler*, 311 F.2d 60 (C.A. 5, 1962). He argues that support for such a characterization of the payments is found in the legal principle that title to property or ownership of property consists of a number of rights in such property, prominent among which is the right of possession. Then he points out that in the condemnation proceedings involved in this case the petitioners were attempting to defend their ownership and possession of their property against P.U.D.'s proposed taking; and that petitioners admittedly were attempting to retain fee simple ownership of their property while granting P.U.D. only a flowage easement. He urges that while a condemnation proceeding may not appear to involve a "defense of title" in the strictest sense, this Court should take a broader view of the concept of defense of title which would encompass the situation involved herein.

We realize the strength of respondent's arguments, and perhaps if we were writing on a clean slate we would accept them and hold against the petitioners. But we are not writing on a clean slate. Over 37

years ago this Court was confronted in *L. B. Realkirt*, *supra*, with the same issue presented in this case under similar circumstances. In that case the City of Cincinnati had lawfully condemned a 25-foot strip of the taxpayer's land which was used in his real estate business, and had attempted to take an additional adjacent area by "excess condemnation." The taxpayer successfully resisted the "excess condemnation" and the dispute arose out of the Commissioner's disallowance of the claimed business expense deduction of his attorneys' fees. There, as here, the Commissioner argued that the legal fees should be capitalized. In allowing the deduction of the attorneys' fees as ordinary and necessary expenses of the business, this Court said at pages 1297 and 1298:

> We next note that the litigation was not in defense of title or to perfect petitioner's title. It was to enjoin the taking of the land itself by the exercise of the power of condemnation, a right of sovereignty. Petitioner's title was assumed to be valid and the effectiveness of the condemnation, if successful, would have depended on the validity of petitioner's title. The decision of the Supreme Court perpetually enjoining the condemnation did not add one cent to the value of petitioner's property, nor did it add any rights of title. We are unable to follow respondent in arguing that the expense so incurred was a capital expenditure.
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> • • • • • • •
>
> It is stipulated that petitioner was "engaged in the business of real estate and investments for his own account." Basic in this business was the ownership, possession, and availability for advantageous development or disposition of the property in question. Being so engaged, it is undoubted that petitioner could have employed a watchman to remain on this very property to prevent unlawful entry or misuse by trespassers. An expenditure for such a purpose would have been an ordinary and necessary expense and allowable as such. Similarly, it would seem that if court action were necessary to oust a trespasser and a lawyer were employed to eject him, the fee paid would be a comparable expense of the business. Such an expense "is directly connected with, or, as otherwise stated (*Sarah Backer*, 1 B.T.A. 214, 216), proximately resulted from, his business." *Kornhauser* v. *United States*, 276 U.S. 145.

In substance and in principle the *Realkirt* opinion is controlling in this case. In our judgment there is no sufficient ground upon which *Realkirt* can be distinguished, and at this stage it is beyond our pioneering spirit to relegate it to the museum of legal history. Accordingly, we follow it and conclude that the petitioners are entitled to deduct the legal fees in question as an ordinary and necessary business expense. As in *Realkirt*, their primary purpose was to retain a fee simple interest in all their orchard property and to fight the threatened condemnation which sought to deprive them permanently of a valuable business asset—the land on which they grew their apples and peaches for sale to their customers. See also *Memphis Memorial Park*, 28 B.T.A. 1037 (1933), affirmed per curiam 84 F. 2d 1008 (C.A. 6, 1936), which allowed the deduction of legal expenses incurred in defending a suit to

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enjoin the use of land for cemetery purposes; and Rev. Rul. 60-261, 1960-2 C.B. 42, stating that where legal expenses are for "a business purpose, such as the use and enjoyment or operation of a business asset already owned, the amount thereof would be deductible as a business expense."

The many cases involving expenses to defend one's property against claims of others are indeed diffuse to an almost maddening degree. See Winokur, "Deductibility of Legal and Other Professional Fees," 1963 So. Calif. Tax Inst. 483–492; and *Brown* v. *Commissioner*, 215 F. 2d 697, 699 (C.A. 5, 1954). Faced with what Justice Frankfurter termed "dialectic conflicts," *Trust of Bingham* v. *Commissioner*, 325 U.S. 365, 378, in this confusing and troublesome area, we prefer to adhere to a controlling precedent rather than veer off in a new direction.

Having determined that the legal fees are deductible as business expenses under section 162(a), we find it unnecessary to consider petitioners' alternative position that they are deductible under section 212(2) as expenses for the "conservation" of property held for the production of income.

To reflect the concessions of the parties on other issues,

Decision will be entered under Rule 50.

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BLAINE M. and VIRGINIA C. MADDEN,
Appellees,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Appellant.

No. 72-2536

OPINION

[April 9, 1975]

Appeal from the Decision of the
United States Tax Court

Before: CHOY and GOODWIN, Circuit Judges, and BURNS,* District Judge.

GOODWIN, Circuit Judge:

The Commissioner of Internal Revenue appeals the judgment of the Tax Court determining that legal fees paid by taxpayers are deductible as ordinary and necessary business expenses under section 162(a), Internal Revenue Code of 1954.[1] We conclude that the legal fees were capital expenses, and reverse.

Blaine M. and Virginia C. Madden own and operate a commercial orchard near Brewster, Washington. In 1966, a county public utility district filed two actions to condemn parts of taxpayers' land for use as a reservoir. Contesting these proceedings, taxpayers unsuccessfully attempted to limit the condemnation to the taking of a flowage easement rather than a fee-simple interest.[2]

In their joint income tax returns for the taxable years ending June 30, 1965 through 1968, taxpayers deducted legal fees incurred in the condemnation proceedings as current expenses under

*The Honorable James M. Burns, United States District Judge for the District of Oregon, sitting by designation.

[1] All section references are to the Internal Revenue Code of 1954, unless otherwise indicated.

[2] A detailed review of these proceedings is reported in the opinion of the Tax Court, 57 T.C. 513 (1972).

§ 162 or § 212.[3] The Commissioner determined deficiencies after denying these deductions on the theory that the legal fees constituted capital expenditures under § 263.

The statutes involved in this appeal are relatively clear. Sections 162 and 212 allow a taxpayer to deduct many current expenses from ordinary income if they are related to business or profit-seeking activity. Once that nexus is established, however, the taxpayer still cannot be sure of deducting the expenses. Rather, an additional question must be answered: Are the expenses "capital" in nature under § 263? If they are capital, they cannot be deducted as business expense. *Woodward v. Commissioner*, 397 U.S. 572, 575 (1970).

In the instant case, all parties agree that the legal expenses were related to business or profit. The sole issue is whether they must be capitalized. Underlying the controversy is the absence of a clear definition of "capital expense".

The line between capital and noncapital expenditure is especially difficult to draw with regard to litigation expenses, which arise in a variety of contexts. However, two of the more common situations giving rise to legal fees are particularly relevant to the instant case: protection of an ongoing business, and the purchase or sale of land.[4] In both of these situations, the Supreme Court has articulated tests for determining whether a legal expense is capital in nature.

Where legal fees may have been spent to protect a business, the question is whether the "suit or action against a taxpayer is directly connected with, or, as otherwise stated * * * proximately resulted from, his business * * * ." *Kornhauser v. United States*, 276 U.S. 145, 153 (1928) (accounting suit brought by former partner regarding partnership profits). *Accord, Trust of Bingham v. Commissioner*, 325 U.S. 365 (1945) (suit involving devolution of assets of estate); *Commissioner v. Tellier*, 383 U.S. 687 (1966) (prosecution for violation of Securities Act by stock underwriter in performance of his business).

[3]Taxpayers segregated their legal expenses in resisting condemnation and in seeking to maximize their award once condemnation was certain. The latter expenses were properly capitalized and are not at issue here.

[4]The Commissioner urges that we examine a third situation—defending title to property—and extend it to apply to the instant case. In light of our resolution of the issues noted here, we do not reach this argument.

Under the standard of the last-cited cases, taxpayers' legal fees were not expended in litigation arising out of, directly connected with, or proximately resulting from their business. Unlike, for example, fees which petitioners might spend to collect money due from the sale of their fruit, these litigation expenses were only tangentially related to the orchard business.

The Supreme Court has recently formulated a standard for determining whether legal fees were involved in the sale or acquisition of land. Rejecting a test based on the taxpayer's "primary purpose" in participating in the lawsuit, the Court used "the simpler inquiry whether the origin of the claim litigated is in the process of acquisition itself." *Woodward v. Commissioner*, 397 U.S. at 577. *Cf. United States v. Gilmore*, 372 U.S. 39, 49 (1963). In using an "origin and character" test, the Court in *Woodward* implied that such a test should be used to characterize litigation expenses whenever its use would be feasible. 397 U.S. at 577-78.

When condemnation litigation involves the price the government will pay the property owner for the condemned land, the litigation expenses must be considered capital expenditures under the above test. *See United States v. Hilton Hotels*, 397 U.S. 580 (1970). The Maddens, however, were litigating the right of the government to take a fee interest instead of a less drastic alternative. We have found no case arising since the decisions in *Gilmore* and *Woodward* that discusses whether or not such expenses are capital in nature.[5]

In looking to the origin and character of the litigation, however, we are compelled to treat the legal expenses as capital in nature. The underlying lawsuit did not arise out of taxpayers' business,[6] but out of the need of a governmental agency for tax-

[5]The court below relied on *L. B. Reakirt*, 29 B.T.A. 1296 (1934), *affirmed per curiam*, 84 F.2d 996 (9th Cir. 1936), which did discuss the tax consequences of resisting condemnation. Although *Reakirt* concluded that the taxpayer's litigation expenses were deductible, the court used a standard based on the taxpayer's purpose in litigating. Since we view that standard as having been repudiated in most cases (*but see Woodward v. Commissioner*, 397 U.S. 572 at 576-77 (1970)), we decline to follow the *Reakirt* rationale.

[6]An example of land-related litigation originating in taxpayer's business activities might be a neighbor's suit to enjoin as a nuisance taxpayer's aerial spraying of his orchard.

payers' land. The public need presumably existed without regard to the consequences to taxpayers' business. The government was attempting to appropriate taxpayers' land and taxpayers were resisting that attempt. Such a controversy is inherently related to the sale and acquisition of land, even though the ultimate sale, if one is made, is a forced sale. *See Hawaiian Gas Products v. Commissioner,* 126 F.2d 4 (9th Cir.), *cert. denied,* 317 U.S. 653 (1942); *Stockton Harbor Industrial Co. v. Commissioner,* 216 F.2d 638 (9th Cir. 1954).

Examining the rationale for an "origin and character" test, we are convinced that it is the correct standard to use in determining the nature of the legal fees at issue here. One reason the Court adopted that test was to avoid "capricious results. If two taxpayers are each sued for an automobile accident while driving for pleasure, deductibility of their litigation costs would turn on the mere circumstances of the character of the assets each happened to possess, that is, whether the judgments against them stood to be satisfied out of income- or nonincome-producing property * * *." *United States v. Gilmore,* 372 U.S. at 48.

Similarly, in *Woodward,* the Court noted that "[a] test based upon the taxpayer's 'purpose' in undertaking or defending a particular piece of litigation would encourage resort to formalisms and artificial distinctions * * *." 397 U.S. at 577.

We believe that rejection of the "origin and character" standard in situations such as that in the instant case would result in allowing different taxpayers to characterize basically similar litigation in the manner that would have the most beneficial tax consequences to each. Although use of the "origin and character" standard allows the governmental agency to determine unilaterally the nature of the litigation, and thus the tax consequences for the taxpayer, we do not think this phenomenon invalidates its application. The agency initiated the condemnation proceedings here for a tax-neutral purpose. Where this is so, there is not inherent unfairness to the taxpayer. Furthermore, all taxpayers with capital assets affected by the agency's actions will be similarly treated. Finally, the element of certainty, particularly desirable in tax law, is enhanced.

Reversed and remanded.

PERNAU-WALSH PRINTING CO., SAN FRANCISCO 4-11-75—400

"SEC. 162. TRADE OR BUSINESS EXPENSES.

[Sec.162(a)]

(a) In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

For purposes of the preceding sentence, the place of residence of a Member of Congress (including any Delegate and Resident Commissioner) within the State, congressional district, Territory, or possession which he represents in Congress shall be considered his home, but amounts expended by such Members within each taxable year for living expenses shall not be deductible for income tax purposes in excess of $3,000."

"Trade or Business Expenses

§1.161-1. Allowance of deductions.

Section 161 provides for the allowance as deductions, in computing taxable income under section 63(a), of the items specified in part VI (section 161 and following), subchapter B, chapter 1 of the Code, subject to the exceptions provided in part IX (section 261 and following), of such subchapter B, relating to items not deductible. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code of 1954 cannot again be deducted under any other provision thereof. See also section 7852(c), relating to the taking into account, both in computing a tax under subtitle A of the Internal Revenue Code of 1954 and a tax under chapter 1 or 2 of the Internal Revenue Code of 1939, of the same item of deduction. [Reg. §1.161-1.]

[T.D. 6291, 4-3-58.]

§1.162-1. Business expenses.

(a) In general. Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or a credit under provisions of law other than section 162. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income.

See paragraph (a) of §1.61-3. Among the items included in business expenses are management expenses, commissions (but see section 263 and the regulations thereunder), labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see §1.162-2), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. No such item shall be included in business expenses, however, to the extent that it is used by the taxpayer in computing the cost of property included in its inventory or used in determining the gain or loss basis of its plant, equipment, or other property. See section 1054 and the regulations thereunder. A deduction for an expense paid or incurred after December 30, 1969, which would otherwise be allowable under section 162 shall not be denied on the grounds tht allowance of such deduction would frustrate public policy. See section 162(c), (f), and (g) and the regulations thereunder. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is deductible, even though such expenses exceed the gross income derived during the taxable year from such business. In the case of any sports program to which section 114 (relating to sports programs conducted for the American National Red Cross) applies, expenses described in section 114(a)(2) shall be allowable as deductions under

section 162(a) only to the extent that such expenses exceed the amount excluded from gross income under section 114(a).

(b) Cross references. (1) For charitable contributions by individuals and corporations not deductible under section 162, see §1.162-15.

(2) For items not deductible, see sections 261-276, inclusive, and the regulations thereunder.

(3) For research and experimental expenditures, see section 174 and regulations thereunder.

(4) For soil and water conservation expenditures, see section 175 and regulations thereunder.

(5) For expenditures attributable to grant or loan by United States for encouragement of exploration for, or development or mining of, critical and strategic minerals or metals, see section 621 and regulations thereunder.

(6) For treatment of certain rental payments with respect to public property, see section 167(l) and §1.167(l)-3. [Reg. §1.162-1.]

[T.D. 6291, 4-3-58. Amended by T.D. 6690, 11-18-63, T.D. 6996, 1-17-69, T.D. 7315, 6-6-74 and T.D. 7345, 2-19-75.]"

Supreme Court, U. S.
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No. 75-806

In the Supreme Court of the United States

OCTOBER TERM, 1975

BLAINE M. MADDEN, ET UX., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

ROBERT H. BORK,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

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We invite the Court's attention to the following facts which indicate that the petition for a writ of certiorari was filed out of time. The judgment of the court of appeals was entered on April 9, 1975 (Pet. App. B-1). No extension of time for petitioning was obtained, and the 90-day period in 28 U.S.C. 2101(c) for petitioning in civil cases expired on July 8, 1975. However, the petition was not filed until December 5, 1975. Since the time limit specified by 28 U.S.C. 2101(c) is jurisdictional, it is respectfully

submitted that the petition for a writ of certiorari should be denied.[1]

ROBERT H. BORK,
Solicitor General.

JANUARY 1976.

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[1]Petitioners assert (Pet. 2) that after the court of appeals rendered its decision, they made an "immediate request for re-hearing" before the court of appeals, and that the "Petition for rehearing was denied" on September 5, 1975. In fact, the only post-judgment documents filed in the court of appeals, and acted on by that court, was a motion for leave to file a petition for rehearing out of time which was denied on September 5, 1975. See Appendix, *infra*. "The filing of an untimely petition for rehearing which is not entertained or considered on the merits, or a motion for leave to file such a petition out of time, if * * * denied by the trial court, cannot operate to extend the time for appeal" (*Bowman* v. *Loperena*, 311 U.S. 262, 266; footnote omitted). In any event, even if petitioners' time did run from September 5, 1975, the 90-day period would have expired on December 4, 1975, one day before the petition was filed.

APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BLAINE M. AND VIRGINIA C. MADDEN,

APPELLEES,

v.

COMMISSIONER OF INTERNAL REVENUE,

APPELLANT.

No. 72-2536

ORDER

FILED SEPTEMBER 5, 1975

Before: CHOY and GOODWIN, Circuit Judges, and BURNS, District Judge.*

The court having considered the matter, appellees' motion to file a late petition for rehearing is Denied.

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*The Honorable James M. Burns, United States District Judge for the District of Oregon, sitting by designation.